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No. 92-1697

In the Supreme Court of the United States

OCTOBER TERM, 1992

CHARLES A. DODGE AND CHRISTINE Y. ROBERTS,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the "bank deposits method" of reconstructing petitioners' income may be used when petitioners (i) had over $700,000 in deposits, (ii) produced no financial records to account for those deposits, and (iii) filed no returns, or returns reporting only minimal income, during the four-year period at issue.

2. Whether certain hospital indemnification insurance proceeds received by petitioner Dodge did not relate to actual, legitimate injuries or sickness, and were therefore not excludable from income under Section 104(a)(3) of the Internal Revenue Code, 26 U.S.C. 104(a)(3).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-13a) is reported at 981 F.2d 350 (8th Cir. 1992). The opinion of the Tax Court (Pet. App. 14a-31a) is reported at 96 T.C. 172 (1991).

JURISDICTION

The judgment of the court of appeals was entered on December 9, 1992. A petition for rehearing was denied on January 20, 1993. The petition for a writ of certiorari was filed on April 20, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners Dodge and Roberts, who are not married, began living together in 1980 (Pet. App. 18a) and have commingled their finances since 1981 (Pet. App. 2a). During the years 1981 through 1984, petitioners received profits from sales of automobiles and jewelry (*ibid.*). In addition, Dodge received substantial amounts in insurance proceeds under 30 to 60 "hospital indemnification" insurance policies ("HIPs") that he carried during that time (Pet. App. 18a-21a).[1] During the years relevant here, Dodge was hospitalized seven times, primarily as a result of falls he purportedly suffered, although on one occasion he was hospitalized for a hemorrhoidectomy (Pet. App. 22a-23a). The physician who admitted him to the hospital on four occasions, Dr. Schroeder, was a personal friend to whom Dodge had lent $50,000 (Pet. App. 23a). During 1981 through 1984, Dodge's HIP policies paid him benefits of more than $257,000, while he incurred actual hospital expenses of only $29,445 (Pet. App. 24a).

2. Dodge filed no income tax returns for 1981 through 1984.[2] Roberts's returns for these years

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[1] A HIP policy typically pays an insured a fixed amount ($25 to $100) for each day he is hospitalized, regardless of his actual hospital expenses or his other insurance coverage. HIPs are subject to exploitation by "insurance speculators" who buy multiple policies and then arrange with "friendly" doctors to be hospitalized for extended periods after purported "slip-and-fall" accidents (Pet. App. 21a).

[2] Dodge was convicted in 1976 of criminal violations of the tax laws. He has a history of failing to file tax returns. *United States* v. *Buttorff*, 572 F.2d 619, 622 (8th Cir.), cert. denied, 437 U.S. 906 (1978). In another case, the Tax Court found him

reported only small amounts of income, none of which came from the sale of jewelry or cars or from any business source (Pet. App. 2a, 25a, 30a-31a).[3] On audit, the IRS undertook to reconstruct petitioners' earnings by analyzing deposit slips from the banks at which they maintained accounts (Pet. App. 25a). The Commissioner found it necessary to use the "bank deposits" method because petitioners furnished no books and records to the revenue agent (*ibid.*).[4] On the basis of a reconstruction of petitioners' income, the Commissioner determined deficiencies in income tax for each of petitioners for 1981 through 1984, together with additions to tax for negligence and for substantial understatements of tax (Pet. App. 15a-16a). Petitioners filed a joint petition to the Tax Court for review of the deficiencies.

3. In the Tax Court, the parties stipulated that nearly $700,000 had been deposited into petitioners' bank accounts during the years at issue and that the deposits were divisible into five categories: (1) HIP "insurance proceeds" of approximately $257,000; (2)

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liable for income tax deficiencies and additions to tax for 1973 through 1975 as a result of unreported income derived in part from tax protester activities. *Dodge* v. *Commissioner*, 46 T.C.M. (CCH) 842, 845 (1983).

[3] Petitioners' assertion (Pet. 16 n.11) that Roberts "has complied with all statutory requirements regarding * * * the reporting of gross income" is thus plainly wrong. As noted by the Tax Court, Roberts "failed to report income that a reasonable person would have reported under the circumstances, namely proceeds from the sale of automobiles and jeweiry" (Pet. App. 30a-31a).

[4] The Tax Court stated that petitioners' records were apparently destroyed by a fire at their home in January of 1984 (Pet. App. 25a-26a).

"not identified" amounts of approximately $93,000; (3) "identified-miscellaneous" amounts of approximately $152,000; (4) "taxable reported" income of $3,658; and (5) "non-taxable" receipts of $187,000 (Pet. App. 26a). The Commissioner regarded the proceeds of Dodge's HIP insurance as taxable. Petitioners contended, however, that the proceeds were excludable from Dodge's gross income under Section 104(a)(3) of the Internal Revenue Code, which excludes from income "amounts received through accident or health insurance for personal injuries or sickness" (26 U.S.C. 104(a)(3)).

4. The Tax Court upheld the Commissioner's determinations. The court found that the HIP insurance proceeds did not qualify for the Section 104(a)(3) exclusion because the statute confines the exclusion to amounts paid "for personal injuries or sickness" (Pet. App. 27a). After expressing doubts as to petitioners' and Dr. Schroeder's credibility, the court found that petitioners failed to establish that Dodge's numerous hospital admissions resulted from actual injuries or sickness, rather than being contrived as part of an insurance speculation scheme (*ibid.*). The court therefore ruled that the insurance proceeds were includable in Dodge's income.

The court also found that petitioners failed to show that the deposits in the "unidentified" and "miscellaneous" categories derived from a nontaxable origin (Pet. App. 28a-29a). The court found that a portion of these deposits was attributable to petitioners' sales of automobiles and jewelry, and the court thus included one-half of such portion in the income of each petitioner (Pet. App. 29a). Most of the remaining amounts were taxed to Dodge (*ibid.*). Finally, the

court sustained the additions to tax for negligence and substantial understatements of tax (Pet. App. 30a-31a).

5. The court of appeals affirmed in part and reversed in part the Tax Court's decision. The court rejected petitioners' argument that the Commissioner bore the burden of proof in this case because the IRS had made a "naked" assessment. The court concluded that "[w]e do not find the Commissioner's use of the indirect bank deposits method, under the circumstances, to be anything less than reasonable and rationally based" (Pet. App. 4a-5a).

The court also upheld—as to six of the seven hospital stays in question—the Tax Court's finding that Dodge's HIP insurance proceeds were not excludable under Section 104(a)(3) because the proceeds had not been received for actual personal injury or sickness (Pet. App. 8a). The court reversed the Tax Court's finding with respect to amounts received in connection with Dodge's seventh hospital stay (for a hemorrhoidectomy), finding that such amounts had in fact been received for a genuine personal injury or sickness (Pet. App. 10a-11a).[5]

The court also generally upheld the Tax Court's finding that petitioners failed to meet their burden of proving that the other deposits at issue were from nontaxable sources (Pet. App. 12a). The court, however, reversed the Tax Court's finding with respect to one $50,000 payment petitioners received, for evidence

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[5] The court rejected petitioners' argument that the Commissioner's contention that the HIP proceeds did not qualify for the Section 104(a)(3) exclusion was a "new matter" on which the Commissioner bore the burden of proof (Pet. App. 7a).

indicated that this amount was in repayment of a loan (Pet. App. 11a-12a).

ARGUMENT

The decision of the court of appeals in this fact-bound case is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. a. In tax litigation, the Commissioner's determination of a deficiency is presumed to be correct, and the taxpayer bears "the burden of proving it to be wrong." *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933); United States Tax Court Rule 142. An exception to that general rule exists for "naked" assessments made without *any* foundation. In that situation, the Commissioner's determination is said to be "arbitrary" and is therefore not entitled to the benefit of the presumption of correctness. See *United States* v. *Janis*, 428 U.S. 433, 441-442 (1976); *Weimerskirch* v. *Commissioner*, 596 F.2d 358 (9th Cir. 1979).

Petitioners err in contending (Pet. 18-21) that the Commissioner's determinations in this case lack any factual foundation and are therefore not entitled to the presumption of correctness. When a taxpayer receives substantial amounts of cash or other liquid assets and is unable or unwilling to provide the necessary records to explain his acquisition of those assets, the Commissioner's deficiency determination based upon the taxpayer's receipts is not a "naked assessment" but is one that is entitled to the normal presumption of correctness.

The decision by the Ninth Circuit in *Delaney* v. *Commissioner*, 743 F.2d 670 (1984), is illustrative. In *Delaney*, the taxpayers did not dispute that they had

brought into the country over $40,000 in gold coins during the two-year period at issue. The taxpayers also gave incomplete or unsatisfactory answers to IRS inquiries concerning their acquisition of the coins. The taxpayers nevertheless contended that the burden of proof was on the Commissioner to establish that the coins were traceable to unreported income.

The Ninth Circuit, in an opinion by then-Judge Kennedy, rejected the taxpayers' contention. The court pointed out that the taxpayers conceded that they had brought the coins into the country and had given incomplete and unsatisfactory explanations about the coins to the IRS. The court held that, in these circumstances, the usual presumption of correctness applies. *Id.* at 672. See also *Erickson* v. *Commissioner*, 937 F.2d 1548, 1551-1552 (10th Cir. 1991) ("Once the Commissioner demonstrate[s] sufficient minimal facts to show an ownership interest in assets possessed by the taxpayers, the presumption of correctness remain[s] with the notice of deficiency and the taxpayers [have] the burden of satisfactorily explaining how they came to possess the liquid assets, and to show why the assets did not represent taxable income in the year in question"); *Schad* v. *Commissioner*, 87 T.C. 609, 618-620 (1986) ("connecting [the taxpayer] to the funds that form the basis of the deficiency is sufficient to give him the burden of proving the deficiency determination erroneous"), aff'd, 827 F.2d 774 (11th Cir. 1987) (Table).

The principle of these decisions applies to this case. Petitioners did not dispute that they had made more than $700,000 in bank deposits during the years at issue. They produced no financial records relating to those deposits. They either filed no returns for the

years at issue or filed returns reporting minimal income. Moreover, evidence pointing to the existence of an insurance speculation scheme was present. Under these circumstances, the Commissioner had "little choice" (Pet. App. 4a) but to use the bank deposits method to reconstruct petitioners' income. See also *Anaya* v. *Commissioner*, 983 F.2d 186, 188 (10th Cir. 1993) ("If the taxpayer fails to keep adequate records, the Commissioner is entitled to use any reasonable means to reconstruct the taxpayer's income"); *DiLeo* v. *Commissioner*, 96 T.C. 858, 867 (1991) ("When a taxpayer keeps no books or records and has large bank deposits, the Commissioner is not arbitrary or capricious in resorting to the bank deposits method for computing income"), aff'd on other grounds, 959 F.2d 16 (2d Cir.), cert. denied, 113 S. Ct. 197 (1992). The deficiency determination based on that method was entitled to the presumption of correctness.[6]

Petitioners err in asserting (Pet. 16, 19) that the decision in this case conflicts with the decision in *Armes* v. *Commissioner*, 448 F.2d 972 (5th Cir. 1971).[7]

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[6] Petitioners appear to contend (Pet. 16, 18-21) that even if the Commissioner's determination was not "arbitrary and capricious" as to petitioner Dodge, it was so as to petitioner Roberts. Due to the commingling of petitioners' funds and their inability to produce records, the Commissioner acted reasonably in determining that the deposits were income to both parties. As noted by the court below, on the facts of this case it would have been "irrational, and also unfair, to arbitrarily assign the joint funds to either Dodge or Roberts" (Pet. App. 5a).

[7] The asserted intra-circuit "conflict" (Pet. 21) between the Eighth Circuit's decision in this case and its prior decision in

In *Armes*, the court held that the Commissioner failed to meet his burden of showing a "likely taxable source" for bank deposits. *Id.* at 975. The evidence in this case meets that standard, for it reflects that petitioners had unreported income from insurance payments and from the sale of jewelry and automobiles. This evidence included copies of financial statements that petitioners submitted to a bank in 1982 and 1983, in which they represented that they were in the business of marketing diamonds and autos, and that their estimated income from their business during those years was between $65,000 and $100,000 (C.A. App. 1342, 1343).

Contrary to petitioners' contention (Pet. 16, 19), the decision in this case also does not conflict with either *United States* v. *Morse*, 491 F.2d 149 (1st Cir. 1974), or *Portillo* v. *Commissioner*, 932 F.2d 1128 (5th Cir. 1991). *Morse* involved a criminal tax prosecution and has no relevance to the burden of proof in civil tax litigation. In *Portillo*, the court held that the Commissioner was not entitled to a presumption of correctness because he did not present "some predicate evidence supporting [his] determination." 932 F.2d at 1133. Such substantiation, according to the court, could include "showing the taxpayer's net worth, bank deposits, cash expenditures, or source and application of funds." 932 F.2d at 1134. In the instant case, of course, it was undisputed that petitioners had made over $700,000 in bank deposits during the years at issue.

Kirsch v. *United States*, 174 F.2d 595 (1949), does not warrant review by this Court.

b. Petitioners also err in asserting (Pet. 28-30) that their ability to identify a non-taxable source for a portion of the deposits prior to trial shifted the burden of proof to the Commissioner as to the tax status of the remaining unexplained deposits. Petitioners' ability to rebut the presumption of correctness as to several items of a multiple assessment does not affect the presumed correctness of the rest of the assessment or alter the burden of proof. *United States* v. *Stonehill*, 702 F.2d 1288, 1294 (9th Cir. 1983), cert. denied, 465 U.S. 1079 (1984); *Zeeman* v. *United States*, 395 F.2d 861, 866-867 (2d Cir. 1968). It "is especially appropriate" for petitioners to retain the burden of proof "in cases, such as this, where the Commissioner and tax court have classified a large portion of the belatedly identified deposits as taxable income" (Pet. App. 6a).

2. Section 104(a)(3) of the Internal Revenue Code excludes from a taxpayer's gross income "amounts received through accident or health insurance for personal injuries or sickness." 26 U.S.C. 104(a)(3). As the language of Section 104 demonstrates, the statutory exclusion presupposes the existence of an actual personal injury or sickness. It is not made applicable merely because there are hospitalizations or the receipt of insurance benefits. The courts below correctly found (Pet. App. 8a, 27a) that the majority of Dodge's hospital admissions did not relate to actual injuries or sickness, but were instead contrived as part of his insurance speculation scheme. The nature of Dodge's alleged injuries, the close relationship between Dodge and the admitting physicians, and the lack of credible testimony from petitioners provide ample support for the lower courts' finding that (with

the single exception noted by the court of appeals) the HIP proceeds were received in connection with Dodge's insurance "program" rather than for personal injuries. This factual finding, concurred in by both courts below, does not warrant further review. *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).[8]

Petitioners err in contending (Pet. 17, 25) that the decision in this case conflicts with this Court's decisions in *Commissioner* v. *Heininger*, 320 U.S. 467 (1943); *Lilly* v. *Commissioner*, 343 U.S. 90 (1952); *Commissioner* v. *Sullivan*, 356 U.S. 27 (1958); *Tank*

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[8] There is also no merit to petitioners' assertion (Pet. 21-22) that the Commissioner's contention that the HIP proceeds did not qualify for the Section 104(a)(3) exclusion was a "new matter" on which the Commissioner bore the burden of proof. A "new matter" is a theory or allegation, pleaded by the Commissioner in his answer, that alters (rather than refines) the determination of the Commissioner in the notice of deficiency. *Abatti* v. *Commissioner*, 644 F.2d 1385, 1390 (9th Cir. 1981); United States Tax Court Rule 142(a). In the notice of deficiency, the Commissioner explained his determination that Dodge had received taxable income during the years at issue by stating generally that "[i]n the absence of adequate records, your taxable gross receipts have been computed on the basis of bank statements" (C.A. App. 477). Petitioners themselves raised the Section 104(a)(3) issue in their Tax Court petition by alleging that "any amounts [Dodge] received * * * were non-taxable insurance proceeds" (C.A. App. 8). The Commissioner denied petitioners' allegation that Dodge's receipts were nontaxable insurance proceeds (C.A. App. 13). The Commissioner's denial of Dodge's nontaxable-insurance-proceeds allegation in his answer was a further refinement of the original determination that Dodge had received taxable income. It did not alter that determination and did not represent a "new matter."

Truck Rentals, Inc. v. *Commissioner*, 356 U.S. 30 (1958); and *Hoover Motor Express Co.* v. *United States*, 356 U.S. 38 (1958). According to petitioners, these cases stand for the proposition that statutory deductions may not be denied unless their allowance would frustrate a "sharply defined" public policy (Pet. 25). Petitioners were not denied the exclusion from income provided by Section 104 on public policy grounds. Instead, as the opinions below make clear (Pet. App. 7a-8a, 27a), the Section 104 exclusion was denied because the insurance payments did not fall within the terms of the statute, which require that the amounts be received "for personal injuries or sickness" (26 U.S.C. 104(a)(3)). The cases on which petitioners seek to rely are simply not on point.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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